

**The Tax Exempt and Government Entities  
Division Should Pursue Additional Methods  
to Identify Potential Fraudulent Activities**

**September 2003**

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DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

INSPECTOR GENERAL  
for TAX  
ADMINISTRATION

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MEMORANDUM FOR COMMISSIONER, TAX EXEMPT AND GOVERNMENT  
ENTITIES DIVISION

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SUBJECT: Final Audit Report - The Tax Exempt and Government Entities  
Division Should Pursue Additional Methods to Identify Potential  
Fraudulent Activities (Audit # 200310016)

Attached is the subject final audit report on the Tax Exempt and Government Entities (TE/GE) Division management's efforts to prevent, deter, and detect fraud. The overall objectives of this review were to determine the adequacy of Internal Revenue Service (IRS) management's efforts to effectively communicate fraud awareness to employees within the TE/GE Division and assess the process used to identify and refer potentially fraudulent activities.

In July 2001, the IRS revised the National Fraud Program to reemphasize preventing, deterring, and detecting fraud. The National Fraud Program included creation of a National Fraud Referral Manager to ensure consistency of the fraud strategy across the IRS; development of Fraud Referral Specialist<sup>1</sup> (FRS) positions to assist in identifying, developing, and making referrals to the Criminal Investigation (CI) function; and establishment of timelines for evaluating fraud referrals for Special Agents in the CI Lead Development Centers.<sup>2</sup>

In summary, we determined that the TE/GE Division generally implemented the guidelines for the National Fraud Program, with one modification. Due to the complexity of their work, Government Entities (GE) function management has decided not to use the FRSs exclusively but instead will coordinate the development of fraud issues directly

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<sup>1</sup> All Fraud Referral Specialists are employed in the Small Business/Self-Employed Division. They are available to assist in fraud investigations and offer advice on matters concerning tax fraud to all IRS operating divisions.

<sup>2</sup> Lead Development Centers coordinate local and national projects initiated to identify specific areas/industries of non-compliance. The Lead Development Centers coordinate fraud referrals with the IRS' operating divisions and provide fraud awareness training to operating division employees.

with the CI function in some cases. Although the TE/GE Division has processes in place to identify and refer potential fraud issues to the appropriate office (e.g., appropriate TE/GE Division field offices, the Small Business/Self-Employed (SB/SE) Division, or the CI function) for further development, additional actions should be taken to place more emphasis on fraud prevention, deterrence, and detection.

In Fiscal Year 2003, TE/GE Division management started taking action to improve their fraud program and identified two areas for future improvement. Exempt Organizations (EO) function management has taken steps to improve coordination with the SB/SE Division and the CI function, and GE function management has worked with the CI function on fraud issues in specific cases. TE/GE Division management should continue these efforts for the EO, GE, and Employee Plans (EP) functions and should establish a process to identify areas most vulnerable to potential criminal fraudulent activity within each function.

TE/GE Division management has identified two areas for future improvement to their fraud program:

- The EO function has identified the need to provide employees with training to trace funds through highly complex transactions, to develop a Fraud and Financial Transactions Unit, to address charitable organization fraud through educational materials and regulatory changes, and to develop the ability to analyze data to determine the high-risk noncompliant areas.
- TE/GE Division management has identified the need to communicate the importance, priority, and methods of deterrence and detection of fraud to their employees. Fraud coordinators<sup>3</sup> were selected to help communicate fraud awareness and assist in the development of fraud referrals.

We identified two additional opportunities for TE/GE Division management to strengthen their fraud program. First, information items with the potential for fraud should be given a higher priority. Information items are referrals of information to the EP, EO, and GE functions from other offices within the IRS or from outside sources. We reviewed the EO function's information item database and determined that 88 information items with the potential for fraud were referred to the field for examination from October 2001 through June 2003. EO function management advised their employees that the detection and deterrence of fraud should be a top priority when discovered. However, we determined that there was no additional priority placed on 75 of the 88 information items<sup>4</sup> when they reached the field. As a result, lengthy delays occurred. These delays could be costly if potential fraud exists and is allowed to continue, or if it becomes difficult to follow up on a lead because the individual making the allegation moves or changes businesses.

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<sup>3</sup> Due to the complexity of the work in the TE/GE Division, the Fraud Coordinator positions were developed in the EP, EO, and GE functions to provide training for TE/GE Division employees and to assist in the development of fraud referrals. TE/GE Division fraud coordinators also coordinate fraud referrals with FRSs in the SB/SE Division and with Special Agents in the CI function.

<sup>4</sup> For the remaining 13 of 88 cases, information was not available to complete the analysis.

Second, abusive tax schemes should be considered for criminal fraud. Abusive tax schemes may represent a high potential for fraud referrals. The EO function is currently working several abusive tax schemes but has not discussed the potential for criminal fraud in these tax schemes with the SB/SE Division FRSs or the CI function. If the CI function accepted any of these as criminal referrals and they led to successful prosecutions, the result may be future tax compliance by the individuals or organizations involved.

We recommended that the Commissioner, TE/GE Division, formalize plans for providing fraud training and establish a process to identify the areas most vulnerable to potential criminal fraud, evaluate externally or internally identified allegations of fraud to determine the appropriate action to take, and coordinate the priority of issues with the CI function.

Management's Response: The Commissioner, TE/GE Division, agreed with our recommendations and initiated or completed corrective actions to address tax fraud. Specifically, TE/GE Division management is implementing plans to provide training to fraud coordinators, has provided fraud training to field employees who conduct examinations, and will provide follow-up training in the future. In addition, they initiated risk assessments in all TE/GE Division functions to identify areas potentially vulnerable to fraud, formed Abusive Tax Transactions Work Groups to address the broad issue of tax abuse and to report potential fraud to the CI function, issued instructions to EO function employees on giving priority treatment to information items in which fraud is suspected, and will coordinate with the CI function to identify a priority for potential fraud issues referred to the CI function. Management's complete response to the draft report is included as Appendix IV.

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.

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## The Tax Exempt and Government Entities Division Should Pursue Additional Methods to Identify Potential Fraudulent Activities

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### Background

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The Tax Exempt and Government Entities (TE/GE) Division became operational in December 1999 to serve a variety of customers that are exempt from Federal income tax laws and governed by highly complex, specialized provisions of the Internal Revenue Code (I.R.C.). The TE/GE Division has three primary functions to support the needs of three distinct customer segments that collectively control assets of approximately \$8 trillion:

- The **Employee Plans** (EP) function is responsible for ensuring that employee and individual retirement plans comply with the appropriate laws and regulations. Currently, there are over 920,000 qualified retirement plans.
- The **Exempt Organizations** (EO) function is responsible for ensuring that organizations exempt from Federal income tax comply with the I.R.C. and related regulations. There are approximately 1.6 million religious, charitable, social, educational, and political organizations exempt from Federal income tax.
- The **Government Entities** (GE) function is further divided into three offices to support the needs of its three distinct customer groups:
  - The Federal, State and Local Governments (FSLG) function is responsible for ensuring that government entities responsible for withholding income tax and paying employment taxes comply with the I.R.C. The FSLG function has responsibility for approximately 87,000 government entities.
  - The Indian Tribal Governments (ITG) function is responsible for coordinating tax issues with approximately 564 Federally recognized Indian Tribes. The tax issues are often complex and require coordination with other Federal Government agencies.
  - The Tax Exempt Bonds (TEB) function is responsible for oversight of more than 450,000 tax exempt bonds worth approximately \$1.8 trillion. This sector has experienced dramatic growth in recent years and

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contains some of the most complex regulations in tax administration.

Although the majority of taxpayers and customers comply with the tax laws, a few willfully attempt to evade their tax obligations through committing acts of fraud. In relation to tax administration, fraudulent acts are deception by misrepresentation of material facts to avoid paying tax.

The Internal Revenue Service (IRS) attempts to reduce fraud by using a combination of prevention, deterrence, and detection techniques. The TE/GE Division attempts to prevent and deter fraud through taxpayer education and examination of tax records to ensure the customer entity is operating as intended. When fraud cannot be prevented or deterred, the IRS seeks to detect the fraud for criminal or civil prosecution.

The IRS Criminal Investigation (CI) function investigates allegations of fraud for the IRS and develops cases for criminal prosecution. The CI function's Internal Revenue Manual contains examples of how fraud can occur within the customer bases served by the three functions of the TE/GE Division. One example of fraud that can occur in the TE/GE Division is the willful diversion of donations from a charitable organization for a purpose other than those permitted by the I.R.C.

The IRS has had a longstanding fraud program in place to address civil and criminal fraud. However, in October 2000, the IRS completed the stand-up<sup>1</sup> of its new organization into four business units.<sup>2</sup> Each business unit has responsibility for developing procedures and establishing priorities for serving its customers. While this new organizational structure enables each business unit to establish end-to-end accountability for its respective customer base, it can result

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<sup>1</sup> The structure of the IRS was modified to eliminate geographical organizations and reorganized into divisions serving groups of taxpayers. The "stand-up" occurred when the new organization met the minimum requirements to become operational.

<sup>2</sup> The IRS' four business units include the TE/GE, the Large and Mid-Size Business, the Wage and Investment, and the Small Business/Self-Employed Divisions.

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in a fragmented approach to the accomplishment of IRS-wide programs. In July 2001, the IRS revised the National Fraud Program to reemphasize the prevention, deterrence, and detection of fraud throughout the IRS. The Small Business/Self-Employed (SB/SE) Division took the lead and worked with the CI function to develop a joint strategy to assist Compliance personnel throughout the IRS in developing potential fraud cases. The following were included in the new National Fraud Program:

- The National Fraud Referral Manager position was created to integrate and ensure the consistency of the revised fraud strategy across the four IRS business units.
- Fraud Referral Specialist<sup>3</sup> (FRS) positions were created to assist in civil and criminal tax fraud identification, development, and referral to the CI function.
- Timelines were established for Special Agents in the CI Lead Development Centers<sup>4</sup> to evaluate fraud referrals from IRS field offices.

In November 2001, the EO function became the first within the TE/GE Division to adopt the procedures developed for the new National Fraud Program. The EP function adopted the procedures in June 2002. GE function management informed us they had not issued formal guidance but were also using the National Fraud Program procedures.

We performed audit work from April through August 2003 in the SB/SE and TE/GE Division Headquarters Offices in Washington, D.C.; the TE/GE Division's EP, EO, and GE Offices in Washington, D.C.; the EP Examinations Office in Baltimore, Maryland; and the EO Classification Office in Dallas, Texas. The audit was performed in accordance with

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<sup>3</sup> All Fraud Referral Specialists are employed in the SB/SE Division. They are available to assist in fraud investigations and offer advice on matters concerning tax fraud to all IRS operating divisions.

<sup>4</sup> Lead Development Centers coordinate local and national projects initiated to identify specific areas/industries of non-compliance. The Lead Development Centers coordinate fraud referrals with the IRS' operating divisions and provide fraud awareness training to operating division employees.



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### **The Tax Exempt and Government Entities Division Should Continue Efforts to Improve Its Fraud Program**

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*Government Auditing Standards.* Detailed information on our audit objectives, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

As stated earlier, the TE/GE Division generally implemented the guidelines for the National Fraud Program. This includes using the FRSs to assist in developing cases prior to their referral to the CI function. However, due to the complexity of their work, GE function management made one modification to the procedures. They have decided not to use the FRSs exclusively but instead will coordinate the development of fraud issues directly with the CI function in some cases.

Although the TE/GE Division has processes in place to identify and refer potential fraud issues to the appropriate office (e.g., appropriate TE/GE Division field offices, the SB/SE Division, or the CI function) for further development, additional actions should be taken to place more emphasis on fraud prevention, deterrence, and detection. Effective fraud control requires three things: the ability to identify emerging patterns of fraud, tools that offer immediate protection once a pattern is identified, and the ability to react quickly and eliminate vulnerabilities before too much damage has been done.

Fraud awareness is critical because individuals, organizations, and the general public rely on the TE/GE Division to ensure that tax exempt entities operate in compliance with the I.R.C. For example, qualified retirement plans are very complex and are generally administered by accountants and attorneys. However, average citizens who invest in retirement plans need assurance from the IRS that the plans are properly administered and that errors are not present that will result in the taxpayer having to pay unexpected tax. In addition, the EO function provides service to tax exempt organizations so the benefits and services they provide to the public are protected. Providing assurance that organizations are complying with the law is crucial so the public is confident that the tax system is administered fairly.

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The CI function received the following referrals of potential fraud cases over the past 3 fiscal years from the TE/GE Division:

**Fraud Referrals Received by the CI Function  
From the TE/GE Division for  
Fiscal Years (FY) 2000-2002**

<b>Fiscal Year</b>	<b>TE/GE Division Referrals</b>	<b>Referrals Accepted</b>
<b>2000</b>	4	0
<b>2001</b>	6	3
<b>2002</b>	1	1
<b>Total</b>	<b>11</b>	<b>4</b>

*Source: The CI function.*

There are several reasons why the TE/GE Division has made only a limited number of fraud referrals in the past several years:

- TE/GE Division management advised us that, in the past, preparing a fraud referral package for the CI function was time consuming and generally did not result in the CI function accepting the referral for further development. The CI function recognizes it will need to work with the TE/GE Division in the development of an effective fraud referral program.
- Since December 1999, TE/GE Division management has had to address the problems related to developing a new organization. For example, since two of the three offices in the GE function did not exist prior to the stand-up, management has primarily focused on building their organization, training a new staff, identifying and building relationships with their customers, and determining how to use their resources to carry out their mission. The EP and EO functions have focused their efforts on customer education and outreach, forging a strong relationship with their customers, and processing determination letter applications to achieve upfront compliance.

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Overall, TE/GE Division management focuses their customer education and outreach efforts on voluntary compliance programs to increase upfront compliance and reduce the need for examinations. This upfront approach to compliance is intended to reduce compliance problems that are not deliberate. Compliance problems can be caused by customers' lack of knowledge, confusion, poor record keeping, differing legal interpretations, unexpected emergencies, or temporary cash flow problems.

- TE/GE Division management works potential fraud cases through their Examination program and has not established a separate priority for working these cases. We provide examples of this later in the report.

Providing outreach, education, and voluntary compliance agreements is appropriate for TE/GE Division customers who want to comply with their tax obligations. However, for those customers who willfully evade their obligations, a stronger approach should be taken. TE/GE Division management should work with the CI function to address willful noncompliance that could be considered criminal or fraudulent.

We identified the following viewpoints from TE/GE Division functional management regarding potential fraud and noncompliance:

- EO function management recognizes that fraud exists within charitable organizations, and their inability to identify fraud is a concern. This concern is due in part to their inability to adequately determine which segments of the charitable community are prone to fraud and their insufficient training in detecting areas of fraud.

When the EO function determines that an organization is not operating in compliance with its tax exempt purpose, the organization's tax exempt status may be revoked or excise taxes may be imposed, depending upon the type and severity of the violation. Once an organization loses tax-exempt status, it will be subject to Federal income tax.

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- GE function management advised us that, generally, their customers are not the types of entities subject to fraud. Rather, it is the employees, agents, or officers that commit fraud within the GE function customer organizations. Because these are individuals instead of tax exempt entities, it would be the responsibility of the SB/SE or Wage and Investment Divisions to pursue the potential fraud issues for these individuals. GE function management tries to assist customers in correcting noncompliance through customer education and outreach programs.
- EP function management advised us that, generally, the fraud and noncompliance problems they see are with promoters<sup>5</sup> of retirement plans. The SB/SE Division is responsible for addressing sponsor<sup>6</sup> fraud and noncompliance issues.

When EP function management determines that an employee retirement plan fails to meet the qualification requirements, the favorable tax treatment for such plans may be denied; that is, the employer may lose tax deductions and employees may have to report benefits on their individual tax returns. As a practical matter, the EP function rarely disqualifies an employee retirement plan. Instead, it may impose sanctions short of disqualification and require the employer to correct any violation of the qualification rules.<sup>7</sup>

In FY 2003, TE/GE Division management started taking action to improve their fraud program and identified two areas for future improvement. In June 2003, the Director, EO, TE/GE Division, organized a meeting with the SB/SE Division and the CI function to determine how to better coordinate fraud issues among the three functions. In addition, GE function management has worked with the CI

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<sup>5</sup> Plan promoters are organizations that create and sell retirement plans to employers (plan sponsors).

<sup>6</sup> Plan sponsors are employers who purchase retirement plans for the benefit of their employees.

<sup>7</sup> *Present Law and Background Relating to Employer-Sponsored Defined Contribution Plans and Other Retirement Arrangements* prepared by the Joint Committee on Taxation (JCX-9-02, dated February 25, 2002).

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function on fraud issues in specific cases. TE/GE Division management should continue these efforts for the EP, EO, and GE functions and should establish a process to identify areas most vulnerable to potential criminal fraudulent activity within each function. This should be coordinated with the CI function to gain a better understanding of the types of fraud that can be developed for prosecution.

The two areas identified by TE/GE Division management for future emphasis include the following:

- The TE/GE Division FY 2005 Strategic Assessment (issued in March 2003) identifies the following issues that need to be addressed for the EO function to achieve its mission:
  - Training is needed to provide employees with the skills to trace funds through highly complex transactions. This will enable them to identify and combat financial fraud and prevent the diversion of money from charitable funds.
  - A Fraud and Financial Transactions Unit should be developed to provide assistance to other offices developing criminal cases and to provide assistance inside the TE/GE Division to identify and develop fraud cases.
  - Educational materials and regulatory changes should be developed and pursued to address charitable organization fraud.
  - The EO function needs the ability to analyze available data to determine the high-risk noncompliant areas within its customer segments.

In accordance with the IRS budget cycle, the TE/GE Division's strategic plans are prepared 2 years ahead. TE/GE Division management will not know whether the initiatives in their FY 2005 Strategic Assessment will be funded until they receive their FY 2005 budget. Accordingly, plans for implementing this EO function initiative have not been made.

- TE/GE Division management plans to communicate the importance, priority, and methods of deterrence and

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detection of fraud to their employees. Fraud coordinators<sup>8</sup> were selected within the three TE/GE Division functions to help communicate fraud awareness and assist in case development of fraud referrals. These Coordinators have not yet been fully trained on their responsibilities; however, future plans are to use the Coordinators to provide technical assistance during the development of fraud referrals and to communicate fraud awareness to TE/GE Division employees. However, we did not identify any formal plans to accomplish this training and communications effort.

In addition to the areas identified by TE/GE Division management, we identified two opportunities for TE/GE Division management to strengthen their fraud program: giving information items with the potential for fraud a higher priority, and considering abusive tax schemes for criminal fraud.

### **Information items with the potential for fraud should be given a higher priority**

Information items are referrals of information to the EO, EP, and GE Classification Sections from other offices within the IRS or from outside sources. These referrals could include suspected noncompliance with the I.R.C. or allegations of potential fraud.

Within the TE/GE Division, the EO function receives the most information items with potential fraud allegations that are referred to the field for examination. We evaluated the EO function's process for handling information items and determined that information items with potential for fraud should be handled with increased priority.

All information items involving exempt organizations are forwarded to the EO Classification Section and maintained

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<sup>8</sup> Due to the complexity of the work in the TE/GE Division, the Fraud Coordinator positions were created in the EP, EO, and GE functions to provide training for TE/GE Division employees and to assist in the development of fraud referrals. TE/GE Division fraud coordinators also coordinate fraud referrals with FRSs in the SB/SE Division and with Special Agents in the CI function.

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on an information item database. Experienced employees (classifiers) are required to begin evaluating information items and referrals within 90 days after the date of receipt to determine if they warrant additional evaluation by field Examination personnel. When the classifiers identify potential violations of the tax law, such as nonpayment of taxes due to unrelated business income or an organization not operating within its tax exempt purposes, they enter this information into an inventory database, and the case is referred to field Examination personnel for further review. If the case is accepted for examination, the revenue agent is responsible for determining if compliance problems or potential fraud exists.

Between October 2001 and June 2003, the EO Classification Section received over 2,400 referrals and information items. The classifiers screened approximately 2,000 information items/referrals and transferred 689 to the field for evaluation. The remaining information items were still awaiting screening or were identified for follow-up in a future year.

We reviewed the EO function's database for the 689 information items/referrals transferred to the field and identified 88 (13 percent) that the classifiers thought warranted further review because of the potential for fraud. We identified these 88 information items/referrals by searching the classifiers' comments for words such as "embezzlement," "fraud," "criminal," and "inurement," which indicate that the classifier believed the case may have fraud potential.

The Directors of the EP and EO functions advised their employees that the detection and deterrence of fraud should be a top priority when discovered. However, we determined that there was no additional priority placed on 75 of the 88 cases<sup>9</sup> when they reached the field for examination. As a result, lengthy delays occurred.

Our analysis of the 75 EO Examination function cases identified the following:

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<sup>9</sup> For the remaining 13 of 88 cases, information was not available to complete the analysis.

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- The 75 cases took between 2 and 422 days (average 186 days) to complete the classification process.
- In 10 of 75 cases, the cases remained in the EO Examination group between 120 and 309 days (average 198 days) before being assigned to a revenue agent for examination.
- In 13 of 75 cases, the cases had been in the EO Examination group between 120 and 383 days (average 265 days) but were not assigned to a revenue agent at the time of our review.
- In 47 of 75 cases, the cases had been in open EO Examination function status between 13 and 383 days (average 133 days) at the time of our review.
- In 5 of 75 cases, the cases were transferred to the CI function for further development. Between 62 and 310 days (average 216 days) had elapsed from the time the cases were assigned to the EO Examination field group until the time they were transferred to the CI function.

These delays could be costly if potential fraud exists and is allowed to continue, or if it becomes difficult to follow up on a lead because the individual making the allegation moves or changes businesses.

We also evaluated the process used in the EP and GE functions for information items. We reviewed the comments made by EP function classifiers on their information item database for cases accepted for examination and identified only one case that EP function management thought warranted further review because of the potential for fraud. The case is currently assigned to a revenue agent.

In contrast to the EO function, ITG function management (within the GE function) informed us they do give potential fraud allegations a higher priority when determining which cases to send to the field. They provided us a recent example in which, upon receipt of the information item, they immediately determined that it needed to be sent to the field for examination to determine if there was criminal fraud potential. Although the FSLG function (within the GE function) maintains a referral database, there are no separate



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procedures for referrals with allegations of fraud. Therefore, we did not review referrals received and/or accepted for examination in the GE function. As a result, we do not know how long it takes to evaluate potential fraud referrals in the GE function.

### **Abusive tax schemes should be considered for criminal fraud**

TE/GE Division management's process to identify and refer potentially fraudulent issues could be improved by considering the criminal fraud potential of abusive tax schemes already being worked by Examination function employees. The TEB function's (within the GE function) Fraud Coordinator monitors and coordinates, with the CI function, the development of fraud referrals and I.R.C. § 6700<sup>10</sup> cases involving the issuance of abusive arbitrage bonds. However, the EO function is currently working several abusive tax schemes but has not discussed the potential for criminal fraud with the SB/SE Division FRSs or the CI function. Abusive tax schemes may represent a high potential for fraud referrals. Obtaining the CI function's input on the criminal fraud potential of these cases could help the TE/GE Division better understand the types of cases that the CI function will accept. If the CI function accepts any of these as criminal referrals and they are successfully prosecuted, the result may be future tax compliance by the individuals or organizations involved in the scheme.

The EO function has the following abusive tax scheme initiatives ongoing:

- **Excessive compensation for officers of exempt organizations** - I.R.C. § 4958<sup>11</sup> provides that payments of salary within an exempt organization should be commensurate with the services provided. It requires the assessment of a 25 percent excise tax on an excess benefit provided by an exempt organization to a person in a position to exercise substantial influence over the affairs of the organization. The EO function monitors

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<sup>10</sup> I.R.C. § 6700 (2002).

<sup>11</sup> I.R.C. § 4958 (2002).

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referrals of I.R.C. § 4958 excise tax for excess benefit transactions.

The Section 4958 Project Team has received approximately 130 referrals from the IRS and other sources. The 25 percent excise tax has been assessed on 5 separate occasions. One of the cases recently closed in the United States (U.S.) Tax Court had an excess benefit transaction amount totaling approximately \$5 million and a 25 percent excise tax totaling approximately \$1.25 million.

- **Promoters of abusive tax schemes** – In general, I.R.C. § 6700 can require that a civil penalty equal to \$1,000 for every violation be assessed against the promoters of abusive tax schemes. I.R.C. § 6700 investigations are generally made in conjunction with I.R.C. § 7408,<sup>12</sup> which is a civil action in the name of the U.S. to prevent any person from engaging in the abusive activity. The civil action is intended to prevent recurrence of the abusive scheme.

The EO function has identified several types of abusive tax schemes, including the following:

- Supporting Organizations (SO) - SOs are created to collect funds for organizations exempt from paying income tax. Money or other items of value donated to these SOs are eligible for charitable deductions by the donor. SOs can be used as a bogus entity to provide a donor with a means to illegally obtain a charitable deduction. This occurs when money is donated to an SO and the SO is operated in such a way that the exempt organization gets little or nothing in the way of actual support. The EO function has identified three abusive promotions involving SOs.
- Vehicle Donations - This type of scheme involves for-profit vehicle dealers obtaining vehicles under the deception that the donor is donating the vehicle to a charitable organization. There are several of these examinations in process.

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<sup>12</sup> I.R.C. § 7408 (2002).

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- Charitable Remainder Trusts (CRT) - A CRT is a trust set up to provide income to a beneficiary over a specific period of time or until all beneficiaries die. When the term of the trust expires, any remaining funds are required to be distributed to a specified charity. These schemes generally involve instances where a donor to a CRT takes a higher deduction than allowed for the CRT. The CRT is primarily used to reduce the amount of taxable income for the donor. Several of these schemes are currently being examined by the EO Examination function.
- Producer-Owned Re-insurance Company (PORC) - Small insurance companies that meet certain criteria can be considered tax exempt. Some U.S. retailers have established PORCs to improperly reroute income earned from the sale of insurance contracts to avoid paying tax. These companies are typically located outside the continental U.S. The EO function is currently examining five of these schemes.

EO function management advised us that they have not discussed the I.R.C. §§ 4958 or 6700 schemes with the CI function to determine if there is criminal fraud potential.

By following through on the action items identified in the TE/GE Division FY 2005 Strategic Assessment, communicating the importance of fraud, giving information items with potential for fraud a higher priority, and considering abusive tax schemes for potential fraud referral, the TE/GE Division can develop a stronger fraud program. A strong fraud program can help increase voluntary compliance by acting as a deterrent to inappropriate activity and by detecting the inappropriate activity when it occurs.

### **Recommendations**

1. The Commissioner, TE/GE Division, should formalize plans for providing fraud training for fraud coordinators and scheduling training for the compliance staff members.

Management's Response: TE/GE Division management established plans to address the broad area of tax abuse in

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their Strategy and Program Plan for FYs 2004 and 2005, and is implementing plans to provide fraud training to the fraud coordinators. In addition, the EP, EO, and GE function employees have received fraud training and will receive follow-up training in the future.

2. The Commissioner, TE/GE Division, should establish a process to:

- Identify areas most vulnerable to potential criminal fraud activity within each of the three TE/GE Division functions.
- Evaluate externally or internally identified allegations or issues of potential fraud, including abusive tax schemes, to determine the appropriate action to take, including fraud referral to the CI function.
- Coordinate with the CI function to determine which potential fraud issues should be prioritized for referral to the CI function.

Management's Response: TE/GE Division management initiated risk assessments in all TE/GE Division functions to identify areas potentially vulnerable to fraud, formed Abusive Tax Transactions Work Groups to address the broad issue of tax abuse and to report potential fraud to the CI function, and issued instructions to EO function employees on giving priority treatment to information items in which fraud is suspected. In addition, they will coordinate with the CI function to identify a priority for potential fraud issues referred to the CI function.

## **The Tax Exempt and Government Entities Division Should Pursue Additional Methods to Identify Potential Fraudulent Activities**

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### **Appendix I**

#### **Detailed Objectives, Scope, and Methodology**

The objectives of the audit were to determine the adequacy of Internal Revenue Service management's efforts to effectively communicate fraud awareness to employees within the Tax Exempt and Government Entities (TE/GE) Division and assess the process used to identify and refer potentially fraudulent activities. To accomplish our objectives, we performed the following audit steps:

- I. Identified actions taken by TE/GE Division management in the Employee Plans (EP), Exempt Organizations (EO), and Government Entities (GE) functions to familiarize and train Compliance employees in potential fraud identification and referral.
  - A. Interviewed TE/GE Division management to obtain an understanding of their role in identifying and referring potential fraud issues.
  - B. Identified other means used by TE/GE Division management to raise TE/GE Division employees' awareness related to the identification and referral of potentially fraudulent activities.
- II. Interviewed TE/GE Division fraud coordinators and determined if they have been actively involved in promoting fraud awareness within the TE/GE Division.
  - A. Determined whether the fraud coordinators had received adequate training to evaluate potential fraud referrals in the TE/GE Division.
  - B. Determined the number of presentations that had been given by fraud coordinators during group meetings, Continuing Professional Education classes, etc., by the time we conducted our fieldwork.
- III. Evaluated the process for identifying and referring information items from receipt through examination in the EP, EO, and GE functions.
- IV. Interviewed EO function management to identify any abusive tax schemes that may have the potential for criminal fraud referral.

**The Tax Exempt and Government Entities Division Should Pursue  
Additional Methods to Identify Potential Fraudulent Activities**

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**Appendix II**

**Major Contributors to This Report**

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**The Tax Exempt and Government Entities Division Should Pursue  
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**Appendix III**

**Report Distribution List**

Commissioner C  
Deputy Commissioner for Services and Enforcement SE  
Director, Employee Plans, Tax Exempt and Government Entities Division SE:T:EP  
Director, Exempt Organizations, Tax Exempt and Government Entities Division SE:T:EO  
Director, Government Entities, Tax Exempt and Government Entities Division SE:T:GE  
Director, Planning and Strategy, Criminal Investigation CI:S:PS  
Chief Counsel CC  
National Taxpayer Advocate TA  
Director, Office of Legislative Affairs CL:LA  
Director, Office of Program Evaluation and Risk Analysis RAS:O  
Office of Management Controls OS:CFO:AR:M  
Audit Liaison: Director, Communications and Liaison, Tax Exempt and Government Entities  
Division SE:T:CL

## The Tax Exempt and Government Entities Division Should Pursue Additional Methods to Identify Potential Fraudulent Activities

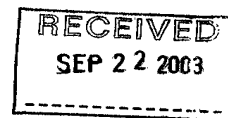
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### Appendix IV

### Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224  
SEP 22 2003



#### MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM

Evelyn A. Petschek, Commissioner  
Tax Exempt and Government Entities

SUBJECT

Response to Draft Audit Report – The Tax Exempt and  
Government Entities Division Should Pursue Additional  
Methods to Identify Potential Fraudulent Activities  
(Audit No. 200310016)

I appreciate your recognition of the importance of discovering and eliminating tax fraud. Although a number of the problems of fraud and abuse encountered in other areas of tax administration generally are not present among the customers of the Tax Exempt and Government Entities (TE/GE) Division, the possibility for individuals to use tax-exempt entities as vehicles for tax fraud does exist.

Your report notes some of the steps TE/GE has taken to address tax fraud. We have implemented the guidelines for the National Fraud Program, including modifications to address special needs in the Government Entities area. We have established Fraud Coordinator positions in our Employee Plans (EP), Exempt Organizations (EO) and Government Entities (GE) functions, and we have stepped up our coordination with SB/SE and Criminal Investigation to identify potentially fraudulent activities. We also have developed plans to establish a Fraud and Financial Transaction Unit in our EO function.

Further, TE/GE's Senior Technical Advisor coordinates the abusive tax-shelter activities of all TE/GE functions, and we are participating fully in Service-wide efforts aimed at stopping tax fraud and abuse. The Senior Technical Advisor also serves on the IRS's Abusive Tax Shelter Executive Steering Committee. We are fully engaged in the effort to identify and stop tax fraud, and have read with interest your suggestions for additional steps we might take.



## **The Tax Exempt and Government Entities Division Should Pursue Additional Methods to Identify Potential Fraudulent Activities**

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We have the following comments in response to your recommendations:

### **RECOMMENDATION 1**

The Commissioner, TE/GE Division, should formalize plans for providing fraud training for fraud coordinators and scheduling training for the compliance staff members.

### **COMMENT**

As we have laid out in our Strategy and Program Plan for Fiscal Years 2004 and 2005 our EP, EO and GE functions have formally established plans to address the broad area of tax abuse. We are implementing plans to provide fraud training to TE/GE's fraud coordinators. Further, EO and GE employees who conduct examinations, or are in a position to encounter tax fraud in the course of their work, received fraud training this year from representatives of the Criminal Investigation function. EP employees received fraud training previously. We have plans to provide appropriate follow-up training. Our plans for providing fraud training and for scheduling training are complete.

### **CORRECTIVE ACTION MONITORING PLAN**

Not applicable. TE/GE has implemented the corrective action.

### **IMPLEMENTATION DATE**

Completed.

### **RESPONSIBLE OFFICIAL**

Not applicable.

### **RECOMMENDATION 2**

The Commissioner, TE/GE Division, should establish a process to:

- Identify areas most vulnerable to potential criminal fraud activity within each of the three TE/GE Division functions.
- Evaluate externally or internally identified allegations or issues of potential fraud, including abusive tax schemes, to determine the appropriate action to take, including fraud referral to the CI function.
- Coordinate with the CI function to determine which potential fraud issues should be prioritized for referral to the CI function

## **The Tax Exempt and Government Entities Division Should Pursue Additional Methods to Identify Potential Fraudulent Activities**

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### **CORRECTIVE ACTION**

We have established Abusive Tax Transactions Work Groups to address the broad issue of tax abuse within our EP, EO and GE functions. In the course of their work, these groups will be alert to issues of tax fraud. When they identify potential fraud, they will report it to CI. The Senior Technical Advisor is coordinating the efforts of these groups for TE/GE. In addition, we have initiated risk assessments in all TE/GE functions. Our risk assessments help us identify areas of non-compliance, including areas potentially vulnerable to fraud.

Further, the Exempt Organizations function has issued instructions to employees to give priority treatment to information items in which fraud is suspected, and to include, in the analysis of abusive tax schemes, an evaluation of whether to refer the item to CI.

We will meet with CI to identify a priority for potential fraud issues that are referred to the CI function.

### **CORRECTIVE ACTION MONITORING PLAN**

We will monitor this corrective action through the Treasury Department's Joint Audit Management Enterprise System (JAMES) system.

### **IMPLEMENTATION DATE**

March 15, 2004

### **RESPONSIBLE OFFICIAL**

Senior Technical Advisor

If you have any questions concerning this response, please call Mike Daly at 202-283-9894.